

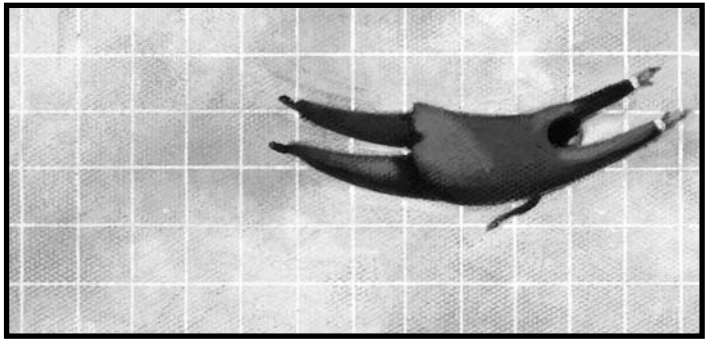
BY GEORGE FEIGER

The current economic cycle, from

Internet boom through Enron bust, has been unusually extreme. The Federal Reserve has responded as expected, lowering interest rates time and again, in an effort to stimulate demand.

These low rates have yet to generate much business investment. But they have made it possible for fiscally challenged corporations and municipalities to issue higher-yielding – and riskier – debt, as Treasury and CD yields have fallen to historic lows. And they have permitted an unprecedented flood of mortgage turnovers by homeowners, who have borrowed hundreds of billions more against their bloated equity to sustain personal consumption.

From the perspective of *demand management*, the overriding priority of the Fed – easy credit – is just what the doctor ordered for recessions. However, returns on bonds, bank CDs and other securities are also a source of income for investors. Indeed, for a minority of relatively affluent retirees, investment returns are the primary source of retirement income. And for them, the last three years have been an unmitigated disaster. A blind



scramble for yield by many of them holds the promise of magnifying this disaster still further.

More ominous, the fate of this small group threatens to become the fate of much larger numbers of retirees in the next few decades, many of whom are far from affluent. With fewer companies providing pensions of any sort, a far greater proportion of retirees will come to rely on investment returns for their bread and butter. Accordingly, the policy of driving down interest rates to rid the economy of recession could easily come to mean extended periods of financial distress for millions. This threat will, in all likelihood, constrain makers of monetary policy. It could also lead to much greater regulation of private savings behavior, and limit the role that today's brokerage-oriented savings industry can play in the retail marketplace.

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LEAN TIMES FOR THE NEARLY RICH

A former business colleague who lives on his savings asked what he should invest in that would yield enough to maintain his standard of living. On reflection, all I could suggest was to buy a laundromat or two, or a do-it-your-

made remarkable gains as interest rates fell. However, many owners of fixed-income securities did not reap the full benefit; holders of mortgage-backed paper – Fannie Mae pass-through securities and the like – have faced the most dramatic prepayment rates we have ever seen. They must now reinvest this capital at derisory rates.

On reflection, all I could suggest was to buy a laundromat or two, or a do-it-yourself car wash.

self car wash. After three years of Fed rate cuts, such investments (of which there are not nearly enough to go around) are about all that are left that generate attractive, reasonably reliable yields.

About half the households in the United States with financial assets exceeding \$1 million (exclusive of primary residence) are supported by retirees. Lower the bar to \$500,000 and the proportion hardly changes. A significant number of these retiree households (precise estimates do not exist) depend in large part on their financial assets for income. And with the exception of those retirees who are truly rich, their economic prospects have come under considerable threat. Most retirees' net worth has fallen significantly along with the stock market. But their income has fallen more.

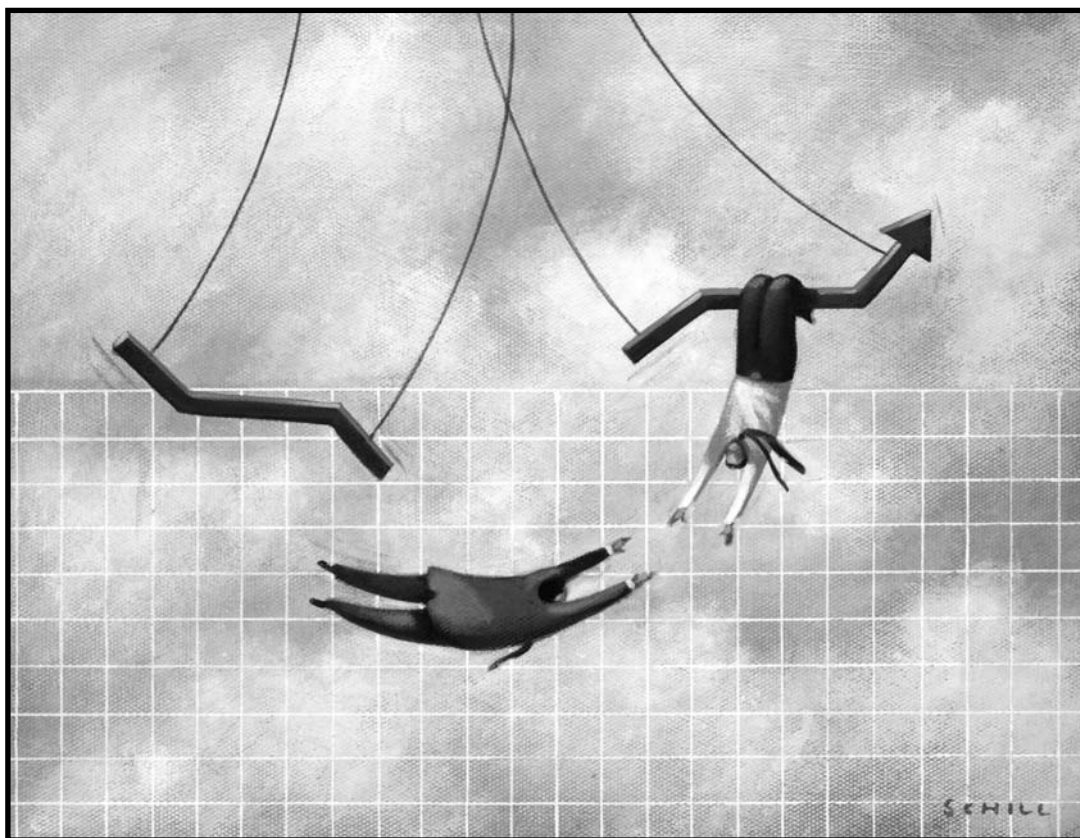
CDs and other short- and medium-term conventional fixed-income investments, now yield just 1 to 2 percent. True, this is the same range as the dividend yield on equities when people were buying stocks by the cartload in the 1990s. But in the market's golden days, investors could always supplement dividend income by realizing capital gains. No longer.

These largely upper-middle-class investors typically owned some bonds, too, which

At the same time, holders of corporate paper have seen much of it downgraded – often to junk status and sometimes into bankruptcy. This same recession has created the greatest crisis in state and municipal finances in a generation, and this has been reflected in the rating of municipal bonds. So investors have been taking capital losses even in the fixed-income asset class.

Overall, then, retirees living on investments have experienced devastating reductions in income – down to just \$10,000 to \$30,000 per year per million dollars of financial assets. Predictably, many of these investors have been aggressively, even desperately, scrambling for higher yields. Wall Street is responding in a way that starkly reveals the risks individuals run in dealing with a commission-driven retail savings industry.

Some of today's hottest investment products are closed-end mutual funds and hedge funds whose strategies are based on asset/liability mismatches. Buy a portfolio of 5- to 10-year municipal bonds, leverage it two or three times with borrowed one-week money, and you can produce a 6 to 7 percent tax-free return. Do the same with taxable interest-bearing securities, and you can produce more than 8 percent – a seductive lure for holders



of IRAs and other tax-deferred accounts.

These products generate very high commissions for brokers, who have been eloquent in explaining the benefits. However, they plainly have not been as eloquent in explaining the extra risk. If the yield curve rises and longer term interest rates sink below short-term rates, investors in the mismatch funds will lose all of their income and much of their capital. Thus, over what is likely to be a six- or seven-year period, they will have taken a double blow – first in equities, then in fixed-income assets.

Prudent financial planners – those who are not recommending leveraged closed-end funds – are already telling middle-income retirees to consume less and to sell their houses. Or even to go back to work.

This is not advice easily given, or followed. Jobs are hard to find these days, especially for people over 60. Moreover, the hot market for housing is showing signs of cooling off. In the affluent suburbs of Boston, for example, there is more real estate on the market now than at any time in recent years.

Sadly, many retirees accustomed to the good life are consuming capital faster than is viable. Even sadder, they will soon have a lot of company in their misery.

A DIFFERENT KIND OF TRICKLE-DOWN ECONOMICS

When free-market economies are working right, what is good for the affluent is also good for the majority. However true that may be, the converse statement – what harms the

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more affluent will end up harming the majority – is almost certainly true in the case of retirement income.

The travails of today's upper-middle-class retirees will, without doubt, be visited in magnified form on the baby boomers. This follows from the fundamental change in how retirement is funded. Since World War II, most retired Americans have depended on a

within a decade or so the majority of retirees will be literally living on yields – or eating into principal.

The irony here should not be lost. The problem that corporate pension plans cannot solve – finding sufficient yields – is trickling down to the retirees themselves. As we have seen, the current crop of more-affluent retirees has not been able to solve this one either.

The Era of Collective Good Feeling in retirement is on the verge of giving way to the Era of “Where’s mine?”

mix of employer-funded pensions and Social Security. Employer pensions, and associated benefits like health insurance, were typically adjusted for inflation.

But these once-commonplace perks are becoming harder and harder to find. Employers are actively capping defined-benefit pension plans and ending post-retirement upgrades of benefits. Yet, in spite of this shift in risk from employer to employee, corporate pension plans on average are seriously underfunded and may be unable to deliver the benefits they (still) promise. Moreover, the magnitude of the funding shortfall vastly exceeds the assets of the government's Pension Benefit Guaranty Corporation.

From time to time, Republicans have floated the idea of moving at least a portion of Social Security contributions to self-directed investment accounts. This mirrors the private sector's desire to push current employees into self-directed retirement plans like IRAs and 401(k)s, with limited employer contributions. While the details of how we will get from here to there are far from clear, it is very likely that

Worse still, the great majority of retirees dependent on private investment returns will have more-limited resources than the more affluent retirees of today. When interest rates are seen from the Fed's demand-management perspective as a cost of borrowing, it is not unreasonable to defer trading in the car or accelerating the purchase of a home as interest rates change. However, for those who rely on investment yields for basic needs, deferral of purchases is simply not possible. You can't skip lunch for 18 months until bank CDs start paying decent returns.

These IRA and 401(k) retirees will not be in a position to buy a car wash to escape from low CD yields. Nor will they be able to sell second homes or to trade down from suburban McMansions to two-bedroom apartments. And when millions of retirees apply for part-time jobs as grocery checkers to make ends meet, supermarkets may or may not wish to hire them.

Put another way, the Era of Collective Good Feeling in retirement is on the verge of giving way to the Era of “Where's mine?”

These concerns will sooner or later make their way to Congress and the White House – not least because the elderly vote more frequently and reliably than the young. And the way politicians cope is likely to have profound implications for both macroeconomic stabilization policy and for regulation of the securities/saving industry.

GREENSPAN (AND THE BROKERS) IN HANDCUFFS

If one American in five lived on interest income, it would take a brave policymaker to drive short-term rates down to current anemic levels. If investment assets were all that sustained these Americans, New York State Attorney General Eliot Spitzer would not have stopped where he did in his recent pursuit of alleged perpetrators in the securities business. And the class-action lawyers would be trying to build a case against the brokerage industry that would make asbestos claims seem paltry.

We have no reliable techniques for ending business downturns or for preventing bubbles in the markets for liquid assets. Recent research into so-called behavioral economics has affirmed that market movements are less inspired by the rationality so beloved by free-market cheerleaders and more by short-term enthusiasm and herd instincts. This makes significant market volatility likely for the indefinite future. That, in turn, means that the conflict between demand management and income management will not go away. In fact, it is likely to compete for the top spot on the economic-policy agenda in coming years. I expect that policy will be pushed in a variety of directions (see box).

It's not clear whether a slower Fed response to economic downturns will make the business cycle more or less volatile. However, there is little question that the other policy

Responding to the yield curve

1. Fed actions will be more tempered. With yield movements driving retiree income, the Fed will have to think twice before changing course. Put bluntly, the baby boom retirees won't take anemic returns lying down.

2. Families will be forced to save. In the end, the best way to ride out volatility is to have a bigger cushion to ride on. Americans are not savers – which is one reason why they succumb so readily to the brokers' siren song of investments that can only go up. The Republican side of the aisle, ever hopeful that people will act in their own interest without a shove from Uncle Sam, won't like the implications. But a likely consequence of dumping the risks of retirement on retirees is a policy, similar to ones already in place in Australia and Singapore, of forcing folks to save a portion of their paychecks, rather than merely encouraging savings with tax breaks.

3. Savings assets will be firmly nudged into less-volatile structures. One way or another, Americans will be encouraged to diversify stock holdings and to "ladder" fixed-income asset maturities to reduce income volatility. Indeed, if Washington forces earners to save, it will probably also force them to invest conservatively.

4. Financial innovators will focus on ways to convert illiquid assets to cash. Now-exotic vehicles for consuming equity – everything from reverse mortgages to shared-appreciation mortgages to viatical life insurance transfers – will become commonplace.

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responses would transform the savings industry. Truly active investing may well become the province of qualified investors with high net worth, just as hedge fund investing is today. Everyone else will be steered toward passively managed, diversified investments like index funds, where transaction costs are

Truly active investing may well become the province of qualified investors with high net worth. Everyone else will be steered toward passively managed, diversified investments where transaction costs are very low.

very low. It follows that there will be little need for a large securities intermediation industry to deliver the goods.

Forced savings will have an even more substantial impact on the wealth-management industry. Total personal savings will presumably rise, but little of this money is likely to find its way into the sort of savings vehicles that generate hefty sales commissions. Rather, as with 401(k) plans today, savings-sales staffs will take on a very different role: helping people invest their forced savings in a prudent manner.

This will come about through the combined pressure of regulation and the interest of employers. An employee who has lost his or her retirement benefits is a disgruntled

employee, whether or not the benefits come from the employer's defined-benefit pension plan. As one increasingly sees in 401(k) plans in the post-Enron era, employers will take a firm hand in making portfolio allocations as stable and as unexciting as possible. This stance will drive employers to take a greater interest in their employees' financial lives.

If savings management largely morphs into customer education, there will be very little room for churning assets. Overall, I would expect the mass-market portion of the wealth-management industry to contract sharply, both in number of agents and in the number of asset-management firms with significant volume of transactions. The asset-management industry will likely be dominated by a modest number of large, low-margin entities like today's index funds, with a significant number of smaller specialty players. Active managers can kiss the retail sector goodbye.

Forced savings may have interesting macroeconomic implications as well. Forced savings do not represent a permanent reduction in consumption, but a deferral of consumption to later in the life cycle. However, at the time of implementation, there will be a temporary reduction in consumption that might persist for many years as the young build nest eggs and the old retrench.

Since the United States is the world's largest importer of consumer goods, this might have global ramifications. For example, China's growth is tied to spending by Americans. In addition, the pattern of consumption later in the life cycle will be different from what we see now. Perhaps big houses and fast cars will be replaced by cruises – or, more likely, high-tech medicine and low-tech assisted living. Certainly, understanding the consumption patterns of people aged 50 and above will prove very valuable. **M**